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Director - Federal Relations

April 3, 1998

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FEDERAL COMMUNICATIONS COMMISSION
OFFICE OF THE SECRETARY

Ms. Magalie Roman Salas
Secretary
Federal Communications Commission
1919 M Street, NW
Room 222
Washington, DC 20554

Re: **Ex Parte Filing**
CC Docket 96-45

Dear Ms. Salas:

On March 26, 1998, several representatives from Ameritech met with the Chief of the Universal Services Branch and her staff to discuss the FCC's upcoming report to Congress on Universal Services (ex parte filed 3/27/98). Specifically, Ameritech addressed the 25/75 federal/state split of responsibility for universal service high cost funding. The attached document more fully develops our position of support for the FCC's decision.

If you have any questions or require additional information, please call me at 202-326-3810.

Sincerely,

Celia Nogales

Attachment
cc: Members of Universal Service Federal/State Joint Board

No. of Copies rec'd 0+2
List ABCDE

Ameritech Position
Universal Service: Federal High Cost Funding
Executive Summary

The issue for federal universal service high cost funding can be reduced to the following questions:

- What High Cost Fund size is appropriate?
- How should alternative proposals be evaluated?
- What are the implications for the state jurisdictions?
- What action should the FCC take?

Background:

Historically, universal service has been a joint responsibility of the FCC and the state commissions and has been funded through a combination of explicit and implicit subsidies. Explicit subsidies at the federal level include the High Cost Loop Fund, DEM Weighting, and Long-Term support. During 1998, the totals for these federal funds will be:

High Cost Loop Fund	$826 M
DEM Weighting	$428 M
Long Term Support	$471 M
TOTAL	$1,725 M

A far larger portion of the subsidies has been and continues to be implicitly buried in rates for services, most of which are in the intrastate jurisdiction. For example, business services have traditionally been priced higher than their cost in order to subsidize basic residential services which have generally been priced below their cost. Other implicit subsidies include higher toll prices (to support local service), higher urban prices (to support rural prices) and higher prices for vertical and other "discretionary" services to support local rates. Various studies attempting to quantify the nationwide amount of implicit subsides have put the total between $4-$20 billion annually.

Funding Alternatives:

Beginning in 1999, the FCC has proposed funding 25% of the difference between the forward-looking cost (as determined by a proxy model) to serve a small geographic area (e.g. a wire center or census block group) and a nationwide revenue benchmark.[1] The carrier receiving such support would be required to lower its interstate access charges by the amount of federal support received. Thus, the implicit subsidies buried in interstate access rates would be converted, over time, to an explicit payment from the federal high cost fund.

[1] The proxy model approach would initially only apply to non-rural LECs. Rural LECs would continue to receive support on the basis of their embedded costs as they do today until, at the very earliest, 2001 at which time they will shift gradually to a forward-looking cost approach.

Several alternative plans have been offered which attempt to answer criticisms of the FCC's proposal that it is "insufficient" and would lead to local rates that are either "unaffordable" or not "reasonably comparable," all in violation of the Act. Among others, they are: 1) expansion of 25% funding to something greater (up to 100%), 2) the Ad Hoc Proposal and 3) the US West "Interstate High Cost Affordability Plan."

Following is a comparison of the fund size generated by the various proposals:

Millions of Dollars

	25% Plan	Ad Hoc	US West Plan	100% Plan
Nationwide High Cost Fund	$2,911	$1,948	$3,837	$11,644

Assessment:

FCC Chairman William Kennard has, on several recent occasions, articulated the principles which underlie the FCC's so-called "25/75" High Cost Funding decision. Essentially, these principles support the Act's vision of a continuing joint responsibility between the FCC and the state commissions for ensuring universal service to rural, insular, and high cost areas. Most recently, he stated the following:

> *"Now comes the hard truth. The vast bulk of universal service support today is generated and spent within the boundaries of each state. This means that the real key to subsidy reform is state, rather than federal action. The law directs the Commission to ensure that service is affordable and comparable, and the Commission clearly must provide a universal service "safety net." But the bulk of subsidies will continue to be raised and distributed within the boundaries of any single state. And unless states act promptly to reform intrastate implicit subsidies, both incumbents and new entrants will be hobbled competitively. States must step up to the plate now. Some states are making progress. I believe that the federal government can play a role in creating incentives for the States to reform their subsidy systems."*[2]

The FCC's plan maintains the historic separations-based division of responsibility for cost recovery and begins addressing the conversion of implicit subsidies (in interstate access rates) to explicit payments from the federal high cost fund. States need to begin reforming the historic system of implicit subsidies in their own jurisdictions. Some have already begun this process. Rate rebalancing has occurred in California, Massachusetts, and Illinois without the adverse effects on subscribership that the naysayers predicted.

Alternatives to the FCC's plan simply seek to shift all or a portion of the state obligation to the federal jurisdiction, a result that Congress did not intend. Section 254 does not even suggest that the FCC change the current balance between federal and state recovery of the costs of providing telephone service.

[2] Quote from speech given to Legg Mason Telecom Investment Precursors Workshop on March 12, 1998.

The FCC's "25/75" solution will do three things: 1) incent state action to rebalance rate structures (i.e., set rational cost based rates), 2) incent state action to identify affordability levels after rebalancing, and 3) focus explicit support to handle highly targeted needs only. These 3 things will, in turn, accelerate the development of facilities based competition for residential customers by providing the proper economic incentives for investment.

Indeed, Wall Street recognizes the detrimental effect of the historic subsidy structure on future investment in the local exchange telecommunications business:

> *"As to a long-term workable solution that would be both equitable to the companies as well as to the vast majority of business and consumer end users, we've advised our clients to look for signs that regulators are prepared to rebalance rates once and for all by lowering business, access, toll and vertical service rates and raising residential rates; and by geographically de-averaging rates."*[3]

Congress envisioned both the development of a vibrant, competitive local communications marketplace as well as the preservation of universal service when it passed the Telecommunications Act. The FCC's "25/75" plan is the only alternative that preserves the joint federal-state responsibility and provides incentives to states to create an environment that makes local residential competition economically attractive. In the process, it will achieve the balance that Congress intended.

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[3] Todd Jacobs, senior telecommunications analyst for Sanford C. Bernstein & Co. in testimony before the Senate Communications subcommittee on March 18, 1998 as quoted in Washington Telecom Week.

Universal Service: Federal High Cost Funding

Issue:

The issue related to federal universal service high cost funding can be reduced to the following questions:

- What High Cost Fund size is appropriate?
- How should alternative proposals be evaluated?
- What are the implications for the state jurisdictions?
- What action should the FCC take?

Background:

Historically, funding for Universal Service has been accomplished through a combination of implicit and explicit subsidies. Implicit subsidies consist of subsidies built into rates for services. For example, business services have traditionally been priced higher than their cost in order to subsidize basic residential services which have generally been priced below their cost. Other implicit subsidies include higher toll prices (to support local service), higher urban prices (to support rural prices) and higher prices for vertical and other "discretionary" services to support local rates. Various studies attempting to quantify the nationwide amount of implicit subsides have put the total between $4-$20 billion annually.[1]

In addition, explicit subsidies at the federal level have existed in 3 forms: the Federal High Cost Loop Fund, Dial Equipment Minute (DEM) Weighting, and Long-Term support. The High Cost Loop fund provides explicit support to LECs with study areas that have loop costs above 115% of the nationwide average loop cost. DEM Weighting provides support for LECs with study areas of 50,000 access lines or less by allowing them to allocate, through the jurisdictional separations process, additional local switching investment to the interstate jurisdiction, there to be recovered from IXCs through higher access charges. Long-Term support is provided to NECA pool participants (generally, small, high-cost companies) to allow them to continue charging the nationwide average carrier common line rates and still recover the full interstate portion of their subscriber line costs. During 1998, the totals for these federal funds will be:

High Cost Loop Fund	$826 M
DEM Weighting	$428 M
Long Term Support	$471 M
TOTAL	$1,725 M

[1] Apples and Oranges: Differences between Various Subsidy Studies, July 19, 1995, Telecommunications Industries Analysis Project

Prior to 1998, these explicit funding mechanisms were paid for by the IXCs, either through a charge per pre-subscribed line (High Cost Loop Fund) or through higher access charges (DEM Weighting and Long-Term support). Beginning in 1998, all interstate telecommunications carriers are contributing to the fund on the basis of their relative share of total interstate and international revenues.

Funding Alternatives:

Starting in 1999, the FCC has proposed funding 25% of the difference between the forward-looking cost to serve a small geographic area (e.g. a wire center or census block group) and a nationwide revenue benchmark[2]. The forward-looking cost would be determined by using a proxy model. For example, if the cost to serve an area, as determined by the proxy model, was $50/line/month and the nationwide revenue benchmark was $30/line/month, then the federal fund would provide $5/line/month to the eligible local exchange carrier serving that area (25% x ($50-$30)). In addition, the carrier receiving such support would be required to lower its interstate access charges by the amount of federal support received. The choice of proxy model, including inputs, and the revenue benchmark have not yet been made by the FCC. States also have the option of submitting a forward-looking cost study for use in calculating the federal support for their state.

The FCC's proposal has been criticized by rural, high cost states and by LECs who serve predominately rural areas. They generally claim that the Act requires "sufficient" support for high cost areas as well as "affordable" and "reasonably comparable" rates. They argue that the FCC's plan fails the sufficiency test by "only" funding 25% of the difference between the cost and the benchmark. Further, requiring recipients of high cost funds to reduce their access charges (rather than allowing such funding to support local rates) will lead to unaffordable local rates in many high cost areas, contrary to the Act's "affordable" and "reasonably comparable" tests. Consequently they are calling for an expansion of the funding beyond 25% and, in some cases, an expansion of the funding base to include intrastate retail revenues.

As a result of the criticisms, several alternative proposals have been advanced. Among others, they are: 1) expansion of 25% funding to something greater (up to 100%), 2) the Ad Hoc Proposal and 3) the US West "Interstate High cost Affordability Plan."

Proponents of expanding the Federal Fund beyond the 25% level argue that 25% does not meet the Act's requirement that support be sufficient. Also, they argue that requiring states to impose surcharges to recover the remaining 75% of funding will cause rates to be unaffordable. For example, North Dakota Public Service Commissioner Bruce Hagen recently stated that the FCC's Proposal "would require a 42 percent intrastate surcharge on North Dakota rate-payers for 75 percent - and that is the worst-case scenario of the cost, and a five percent interstate surcharge of 25 percent of the cost."[3]

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[2] The proxy model approach would initially only apply to non-rural LECs. Rural LECs would continue to receive support on the basis of their embedded costs as they do today until, at the very earliest, 2001 at which time they will shift gradually to a forward-looking cost approach.

[3] Statement during FCC En Banc in Connection with Report to Congress on Universal Service, March 6, 1998.

The Ad Hoc Proposal funds 75% of the difference between the cost (lower of embedded and forward-looking) and the national average cost. There is a "hold harmless" provision in the plan whereby, in no case would any state or study area receive less in federal funding than they do today. There is no requirement to offset receipts from the fund with interstate access charge reductions.

The US West Plan would provide 100% federal funding for areas whose forward-looking cost, as determined by the proxy model exceeded $50/line/month and 25% funding for areas whose forward looking cost is between $30-$50. There apparently is no requirement to reduce access charges by the amount of funding received

Following is a comparison of the fund size generated by the various proposals:

Millions of Dollars

	25% Plan	Ad Hoc	US West Plan	100% Plan
Nationwide High Cost Fund	$2,911	$1,948	$3,837	$11,644

Assessment:

On February 9, 1998, FCC Chairman William Kennard gave a speech to the National Association of State Utility Consumer Advocates in which he outlined the following 8 principles for universal service to be a "balanced package to be taken as a whole -- no picking and choosing." Ameritech agrees with the Chairman's principles and offers the following supportive rationale:

PRINCIPLE 1. "UNIVERSAL SERVICE REFORM SHOULD NOT REDUCE THE AMOUNT OF EXPLICIT SUPPORT THAT THE STATE RECEIVES FROM THE INTERSTATE JURISDICTION. BY THIS, I MEAN THAT COSTS THAT PREVIOUSLY HAD BEEN BORNE BY THE INTERSTATE JURISDICTION BECAUSE OF THE OLD HIGH COST FUND SHOULD CONTINUE TO BE BORNE BY FEDERAL UNIVERSAL SERVICE MECHANISMS."

Ameritech Position and Rationale: Ameritech agrees that costs previously borne by the interstate jurisdiction under the old high cost fund should continue to be borne by federal universal service mechanisms. Furthermore, support should be directed to carriers and not state commissions. Because the Act contemplates separate state and federal funds, intrastate revenues should not be part of the funding basis of any federal high cost fund.

The 25/75% split in funding is historically consistent with traditional state/federal separations precedent. In general, the FCC's proposed 25/75 split most closely approximates the current flow of support on a going forward basis even though it expands the fund size from \$1.7B to \$2.9B[4]. In order to give states time to remove implicit support in their jurisdictions, the requirement that interstate access charges be reduced by the amount of federal support received could be phased in on a carrier specific basis over time. However, any support that goes beyond the current level of federal high cost support should result in immediate interstate access charge reductions.

Expansion beyond 25%, while consistent in its support mechanism, would create a huge windfall in that the fund would be expanded to \$ 11.6B (assuming 100% funding- which would likely be unsustainable) and would likely include intrastate revenues in the funding basis.

Furthermore, expansion of the Federal fund to 100% would eliminate the historical and complementary state role in universal service support as envisioned by section 254 of the Act. As Commissioner Harold Furchtgott Roth recently explained:

> *"Section 254(d) speaks to federal authority over universal service, authorizing the Commission to establish a federal universal service fund subsidized by interstate carriers: "Every telecommunications carrier that provides interstate telecommunications services shall contribute on an equitable and nondiscriminatory basis, to the specific, predictable, and sufficient mechanisms established by the Commission to preserve and advance universal service." 47 U.S.C. section 254(d). Section 254(f),in turn, addresses the role of the states in universal service. It carefully preserves state authority to create support mechanisms not inconsistent with any federal program and leaves to the states the regulation of intrastate carriers: "Every telecommunications carrier that provides intrastate telecommunications services shall contribute, on an equitable and nondiscriminatory basis, in a manner determined by the State to the preservation and advancement of universal service in that State." Id. section 254(f). Both the language and the structure of sections 254(d) and 254(f) clearly indicate that Congress intended that both federal and state governments have separate, but complementary, roles in providing universal service."*[5]

The Ad-Hoc proposal would keep the fund size modest (\$1.9B) but change the support mechanism such that certain carriers and states would receive windfalls[6] and establish administration via state block grants.

The US West proposal would expand the fund size to \$3.8B.

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[4] Support based on BCPM, Version 3.0 using \$31 residential benchmark and \$51 single-line business benchmark.

[5] Statement of Commissioner Harold Furchtgott-Roth regarding the second quarter 1998 Universal Service Contribution Factors, March 20, 1998.

[6] For example, Mississippi would receive over 4.5 times the current level of support (\$107M vs. \$23M); South Carolina would receive 2.7 times current support (\$106M vs. \$39M) and Maine would receive 4.5 times current support (\$50M vs. \$11M). 20 states would receive no more than they do today, including the 5 states in the Ameritech region (Illinois, Indiana, Michigan, Ohio and Wisconsin).

<u>PRINCIPLE 2.</u> "STATES HAVE AN OBLIGATION TO TAKE ALL REASONABLE STEPS AS PROMPTLY AS POSSIBLE TO REFORM EXISTING INTRASTATE UNIVERSAL SERVICE SUPPORT MECHANISMS TO MAKE THEM COMPATIBLE WITH COMPETITIVE LOCAL MARKETS BY MAKING THE SUBSIDIES EXPLICIT AND PORTABLE."

<u>Ameritech Position and Rationale</u>: The Act clearly envisions a shared federal and state responsibility to move from implicit to explicit support mechanisms. Indeed, Chairman Kennard said it best:

> *"Now comes the hard truth. The vast bulk of universal service support today is generated and spent within the boundaries of each state. This means that the real key to subsidy reform is <u>state</u>, rather than <u>federal</u> action. The law directs the Commission to ensure that service is affordable and comparable, and the Commission clearly must provide a universal service "safety net." But the bulk of subsidies will continue to be raised and distributed within the boundaries of any single state. And unless states act promptly to reform <u>intrastate</u> implicit subsidies, both incumbents and new entrants will be hobbled competitively. States must step up to the plate now. Some states are making progress. I believe that the federal government can play a role in creating incentives for the States to reform their subsidy systems."* [7]

Contrary to popular wisdom, it is possible to move to intrastate explicit support without requiring subscribers to pay unaffordable rates. In fact, it has already been undertaken in several states (see Appendix A for discussion of California, Massachusetts, and Illinois experience).

All intrastate support mechanisms must be made explicit -- urban to rural, toll to local, business to residence and access to local. Rates must be rebalanced so as to be cost based and economically rational to include a reasonable measure of contribution. Failure to do so will result in very little, if any facilities based residential competition. This is the message that Wall Street Analysts are giving to Congress:

> *"As to a long-term workable solution that would be both equitable to the companies as well as to the vast majority of business and consumer end users, we've advised our clients to look for signs that regulators are prepared to rebalance rates once and for all by lowering business, access, toll and vertical service rates and raising residential rates; and by geographically de-averaging rates."* [8]

It is critical that rate rebalancing be accomplished on as close to a company revenue neutral basis as possible. Rate rebalancing must be a pre-requisite to state high cost fund participation. Also, before any state high cost funds are created, state commissions must make affordability determinations after rate rebalancing is completed. Any state high cost funds

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[7] Quote from speech given to Legg Mason Telecom Investment Precursors Workshop on March 12, 1998.
[8] Todd Jacobs, senior telecommunications analyst for Sanford C. Bernstein & Co. in testimony before the Senate Communications subcommitte on March 18, 1998 as quoted in <u>Washington Telecom Week.</u>

should be highly targeted and limited to those customers who cannot afford to pay the rebalanced rates. In addition, state high cost funds should minimize any intercompany subsidy flows

<u>PRINCIPLE 3.</u> "STATES SHOULD CONTINUE TO COLLECT AS MUCH OF WHAT IS CURRENTLY INTRASTATE UNIVERSAL SERVICE SUPPORT (WHETHER IMPLICIT OR EXPLICIT) FROM WITHIN THEIR OWN STATE."

<u>Ameritech Position and Rationale:</u> Again, state high cost funds should only be created after state commissions have made affordability and comparability determinations subsequent to rate rebalancing. Any state funds that are then necessary should be as small as possible, targeted to those areas/customers where rates are not affordable, and should limit or eliminate the amount of intercompany support flows. Finally, all intrastate fund contributors must be afforded a competitively neutral mechanism for recovery of their contributions. An explicit surcharge on the end user bill would be the most competitively neutral.

<u>PRINCIPLE 4.</u> "WHERE A STATE HAS FULLY REFORMED ITS OWN UNIVERSAL SERVICE MECHANISMS AND WOULD BE COLLECTING AS MUCH OF WHAT IS CURRENTLY INTRASTATE UNIVERSAL SERVICE SUPPORT AS IS POSSIBLE, ADDITIONAL FEDERAL UNIVERSAL SERVICE SUPPORT SHOULD BE PROVIDED TO ANY HIGH COST AREAS WHERE STATE MECHANISMS IN COMBINATION WITH BASELINE FEDERAL SUPPORT, ARE NOT SUFFICIENT TO MAINTAIN RATES AT AFFORDABLE LEVELS."

<u>Ameritech Position and Rationale:</u> "Fully reformed" must mean that all rates are cost based and include a reasonable measure of contribution. States have the obligation to demonstrate that state mechanisms needed after rebalancing has occurred (up to at least a minimum benchmark) are insufficient before additional federal high cost funding is provided. Any and all sums received must be paid to carriers and narrowly targeted to only high cost areas or low income customers.

<u>PRINCIPLE 5.</u> "FEDERAL UNIVERSAL SERVICE SUPPORT SHOULD BE THE MINIMUM NECESSARY TO ACHIEVE STATUTORY GOALS."

<u>Ameritech Position and Rationale:</u> The FCC proposal ("25/75") maintains the current support flow mechanism and recipient population without creating a windfall situation. Other proposals either create such windfalls, or distort and change the current mechanism in terms of recipient base. Expansion of the funding level beyond the proposed 25/75 formula will have the effect of dis-incenting big recipient states in terms of addressing implicit intrastate support mechanisms. Also, creation of an increased high cost fund has the effect of penalizing subscribers in states which have undertaken a measure of rate rebalancing by requiring them to, in effect, overly subsidize subscribers in other states that haven't addressed their historical

monopoly pricing structure.

PRINCIPLE 6. "FEDERAL AND STATE UNIVERSAL SUPPORT MECHANISMS SHOULD COLLECT CONTRIBUTIONS IN A COMPETITIVELY NEUTRAL MANNER."

Ameritech Position and Rationale: Federal and state fund sizes should be minimized via rebalancing. Any necessary funds should be narrowly targeted to those companies whose subscriber rates would be unaffordable absent the support. Intercompany subsidy flows should be limited. Finally, a competitively neutral recovery mechanism must be in place in both jurisdictions and collection should be from all telecommunications carriers, including ISP's.

PRINCIPLE 7. "FEDERAL AND STATE UNIVERSAL SERVICE SUPPORT MECHANISMS SHOULD ENCOURAGE EFFICIENT INVESTMENT IN NEW PLANTS AND TECHNOLOGIES BY ALL ELIGIBLE TELECOMMUNICATIONS CARRIERS."

Ameritech Position and Rationale: Economically rational intrastate rate structures are an absolute pre-requisite to economically efficient investment and entry. Rationalizing residence rate structures should incent an additional measure of competitive entry focused on the residence market thereby stimulating investment in infrastructure and new technologies.

PRINCIPLE 8. "FEDERAL AND STATE UNIVERSAL SERVICE SUPPORT MECHANISMS SHOULD PROMOTE SERVICE TO HISTORICALLY UNDERSERVED AREAS -- NATIVE AMERICAN NATIONS, FOR EXAMPLE."

Ameritech Position and Rationale: Rational Federal and State pricing structures as outlined, aboved together with targeted high cost funding where rates would be unaffordable will encourage and promote service to all areas including historically underserved areas.

Summary:

Section 254 of the Act clearly envisions the continuation of the historic joint responsibility of both the FCC and the State commissions in ensuring universal service to rural, insular, and high cost areas. The FCC's 25/75 proposal best recognizes that joint responsibility and seeks to preserve it. Other proposals seek to shift all or a portion of the state obligation to the federal jurisdiction, a result that Congress did not intend. As Hayes Griffin, Chairman of Vanguard Cellular has stated "There is nothing at all in section 254 that suggests, let alone requires, that the FCC change the current balance between federal and state recovery of the costs of providing telephone service." [9]

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[9] Statement during FCC En Banc in Connection with Report to Congress on Universal Service, March 6, 1998.

Furthermore, there is no evidence that the current level of federal support for intrastate costs is insufficient. Attempts to increase the size of federal funding are nothing more than attempts by certain parties to increase the burden on other states and their ratepayers. Instead, it is time for the states to "step up to the plate" and begin addressing the implicit subsidies in their respective jurisdictions. Again, to quote Mr. Griffin: "The real problem faced by the states is the same problem that the Commission has had to confront in its own universal service proceedings. The states have to eliminate implicit subsidies and replace them with explicit subsidies."[10]

The FCC's "25/75" solution will do three things: 1) incent state action to rebalance rate structures (i.e., set rational cost based rates), 2) incent state action to identify affordability levels after rebalancing, and 3) focus explicit support to handle highly targeted needs only. These three things will, in turn, accelerate the development of facilities based competition for residential customers by providing the proper economic incentives for investment.

Some are suggesting that the FCC delay implementation of the "25/75" solution until local competition has developed sufficiently. For example, Joel Lubin, Regulatory VP-Law and Public Policy-AT&T recently stated: "AT&T now urges the Commission to delay the transition to the proxy methodology for determining high-cost support for major LECs, which is scheduled to begin in January, 1999, at the very least until these companies have opened their markets to robust and widespread competition."[11] Such views, however, ignore the fact that the current system of implicit subsidies is one of the major deterrents to local competition. Simply put, effective economic competition cannot coexist with the historic monopoly pricing structure containing implicit subsidies. Any delay in reforming this system will ultimately result in consumers being denied the benefits of the "robust and widespread" competition that AT&T and others purportedly desire.

On the contrary, it is time for the FCC to move forward and begin the process of replacing implicit subsidies with explicit subsidies, where needed. Congress envisioned both the development of a vibrant, competitive local communications marketplace as well as the preservation of universal service when it passed the Telecommunications Act. The FCC's "25/75" plan is the only alternative that preserves the joint federal-state responsibility and provides incentives to states to create an environment that makes local residential competition economically attractive. In the process, it will achieve the balance that Congress intended.

[10] *ibid.*

[11] ibid.

Appendix A

Rate Rebalancing:

The existence of the historic subsidy feature in local exchange telecommunications pricing is well documented and thoroughly understood by regulators and economists. The monopoly character of telecommunications markets allowed policy planners and regulators to balance the achievement of efficient prices with other goals --i.e. universal service.

In response to the development of competitive pressures, a number of states began the process of adjusting rates to better reflect the underlying price-cost relationship, and better prepare for an increasingly competitive environment. Most noteworthy among these initiatives were the efforts in Illinois, Massachusetts, and California.

Illinois:

- The Illinois commission has gone as far, if not further, than any other commission in aligning rates with the underlying costs.
- From 1983 to 1988 the ICC transitioned intrastate carrier common line charges to local end user charges on a statewide basis, including rural companies thereby eliminating the intrastate carrier common line charge completely.
- Beginning with divestiture, and over the course of three rate cases the commission approved a state wide rate deaveraging for local loop rates wherein geographic cost disparities were accommodated for Ameritech.
- Ameritech has recently announced yet another pending rate initiative wherein residence and business local loop rates will be brought to parity with increases in residence rates of $.70, $ 1.70 and $2.50 against a base of $6.05, $ 9.03, and $ 12.50 respectively.
- The initiative will be revenue neutral in that carrier access (PICC and traffic) and business local loop rates will be reduced to match the increased revenue from residence local loop increase.
- Consumers can expect to receive a total $ 40 M IXC reduction in intrastate toll rates to match the Ameritech reduction in carrier access charges.

Massachusetts:

- The Massachusetts commission recognized that historic pricing policies were creating barriers to market entry and thus ordered a change in price structure.

> *"Traditionally, the pricing of telephone service was based on a method whereby residential monthly exchange rates were priced below cost in order to promote universal service; and long-distance, toll, and business rates were priced above cost in order to subsidize residential exchange rates. While this system succeeded in serving a social purpose, it was a pricing scheme not conducive to the development of a fully-competitive market, in which the benefits associated with competition would be*

realized by all customers."[12]

"[P]roperly defined incremental costs should be used as the primary basis for pricing all services, including local exchange service...to the extent that current rates do not reflect an appropriate allocations of costs, the [MDPU] will, consistent with the need to avoid major discontinuities in rate levels, move toward that goal."[13]

- Moving prices more in line with incremental costs required a significant shift in revenue recovery -- the price for basic residential dial tone service (1MR) was moved from $ 3.31 in 1991 to $ 9.91 in 1994 (net of SLC). At the same time, flat rate service priced at $ 9.95 in rural areas and $ 12.38 in urban areas was priced at $ 16.85 statewide.
- All the price changes were accomplished in a revenue neutral manner wherein increases were offset by decreases in other services (toll and carrier switched access).
- Affordability, as measured by penetration levels, showed no statistically significant change over the same period.

<u>California:</u>

- In 1994 the California PUC approved (94-09-065) a price-cost realignment plan for Pacific Bell and GTE. The plan was revenue neutral and resulted in significant increases in residence and business basic exchange rates, with offsetting decreases in toll and carrier access rates. Residential flat rate charges for Pacific Bell rose from $ 8.35 to $ 11.25, while the corresponding rates for GTE were increased from $ 9.75 to $ 17.25.
- Rate rebalancing caused no adverse impact on subscribership in California as the penetration level remained essentially constant following the order.

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[12] New England Telephone, Massachusetts D. P. U. 93-125 (1994), pp. 10-11

[13] IntraLATA Competition, Massachusetts D. P. U. 1731 (1985), pp. 36-38. It is important to note that relying on incremental cost as the basis for a more rational rate structure is not the same as setting telephone prices <u>at</u> incremental cost. Significant joint and common costs in the telephone industry require that prices for all service be set above incremental cost.

Conclusion:

The lesson to be derived from each of these separate experiences is that a large measure of intrastate rate rebalancing can be accomplished and be politically acceptable if the respective state commissions adhere to the following ground rules:

1. All intrastate rates must be made part of the equation -- intrastate carrier access, toll, local loops, etc.
2. The rebalancing must at a minimum be revenue neutral at the carrier level, i.e. the net of increases/decreases must be zero.
3. Reductions in intrastate carrier access rates must be flowed through to consumers on as broad basis as possible
4. Rebalancing may need to be introduced on a transitional basis over an appropriate time sequence.
5. Rebalancing target rates should equate to cost (TSLRIC) plus an appropriate allocation of joint and common costs
6. Rate rebalancing should be designed to eliminate implicit subsidies and to develop rate parity for like services
7. Affordability monitoring process must put in place to supplement rebalancing efforts